profitability. Regardless of which strategy competing MVPDs follow, the integrated firm could increase its overall profitability through increased revenues from higher program licensing rates and/or increased cable revenues resulting from higher subscriber rates or greater market share.

Consequently, despite the program access rules, vertically integrated MSOs can, and do, inhibit the development of alternative video program distribution channels by denying new entrants' access to quality programming on reasonable and nondiscriminatory rates, terms and conditions.

D. Cable operators are also acquiring ownership interests in firms that control technology essential to all cable operators.

Ameritech is concerned that the foregoing conditions in the market for video programming distribution are rapidly being replicated in the market for broadband cable technologies and services. This is because the largest MSOs are ominously forging vertical links with providers of technology and services (such as cable set-top boxes; interactive, electronic program guides; and cable modem Internet access services) that will be essential in the emerging digital marketplace. TCI, for example, has acquired a ten percent interest in General Instrument Corp. ("GI"), one of only two manufacturers of digital cable set-top boxes in the United States, in return for GI's assuming control of TCI's Headend in the Sky ("HITS") data control center. In addition, TCI, Time Warner, Cox, Comcast and Cablevision entered an agreement with GI to purchase between 6.9 and 11.5 million advanced digital set top boxes over three years. As part of that transaction, these cable operators received warrants to purchase discounted shares in GI, potentially giving TCI a 20 percent stake in GI. Significantly, these cable operators paid little or nothing for these warrants, but rather obtained them as a result of their significant buying power.

TCI has also attempted to corner the market for electronic programming guide technology and services[63] through its acquisition of United Video Satellite Group ("UVSG"), and UVSG's purchase of TV Guide and hostile takeover bid for Gemstar International Group, Ltd. ("Gemstar"). TCI now owns 73 percent of UVSG, which provides its electronic programming guide, Prevue Channel, to 13.5 million homes across the country, most of which subscribe to TCI. In June 1998, UVSG purchased TV Guide from NewsCorp. Once that transaction is completed, TCI will own 44 percent of UVSG, while NewsCorp will own 40 percent. Moreover, just last month, UVSG launched a hostile takeover bid for Gemstar, which Gemstar has thus far blocked. If this bid is renewed and successful, however, TCI would control all of the electronic programming guide technologies and services currently available, permitting it to demand outrageous fees, and to favor advertisers and programmers with which it is affiliated or with which it has agreements.

In addition, TCI, Cablevision, Comcast, and Cox have created a consortium, @Home Network, that will develop software and provide integration services for up to 11 million advanced digital set top devices for high speed data services. Microsoft Corp.

[63] As cable systems shift to digital, and increase system capacity, electronic programming guides will become increasingly important as a means for viewers to find their way through the maze of hundreds of channels.

and Sun Microsystems are also participating in this development effort.[64] Thus, these cable MSOs are in a position to set the standard for, and gain control of, critical cable modem technology. Through their acquisition of interests in providers of cable modem and other essential technologies and services, incumbent MSOs threaten to become literally the gatekeepers for competition on the information superhighway.

As a result of the foregoing transactions, the anticompetitive problems in the programming market may soon be replicated in the market for technologies and services that will be essential in the broadband, digital marketplace. In particular, vertically integrated MSOs may attempt to use their links with providers of such technologies and services to disadvantage competing MVPDs, and lock-in monopoly profits. Indeed, incumbent cable operators have already denied new entrants, like Ameritech, membership in, CableLabs, a forum established by incumbent cable operators to develop standards for digital set-top boxes, cable modem and other cable technologies.[65] Ameritech is concerned that CableLabs will establish standards that are incompatible with its existing network, and which will therefore limit its ability to compete in emerging broadband markets. As yet, the Commission has not exercised jurisdiction over such activities. Nevertheless, it should not take any action here that would increase the incentive or ability of cable MSOs to use their vertical links with equipment manufacturers and

[64] In addition to cable MSOs vertically integrating backward into critical upstream equipment and technology markets, technology suppliers are forging vertical links with downstream cable operators. For example, just over a week ago, Paul Allen, co-founder of Microsoft Corp., agreed to purchase Charter Communications Inc., the twelfth largest MSO. When combined with the assets of Marcus Cable Co., the eleventh largest MSO, which Allen purchased last April, this acquisition will make Allen the seventh largest MSO in the nation. Kent Gibbons, *No. 7 – With a Bullet*, MULTICHANNEL NEWS, August 3, 1998, p. 1.

[65] New entrants, like Ameritech, have also been denied participation in other collaborative activities, including membership in NCTA and participation in local advertising interconnects.

intellectual property owners to disadvantage competitors. In addition, the Commission should seek authority from Congress to prevent such anticompetitive conduct.

III. Increasing the Horizontal Ownership Limits or Relaxing the Cable Attribution Criteria Would Increase Horizontal Concentration and Vertical Integration in the Cable Industry and Therefore Permit Incumbent Operators to Limit Nascent Competition to Cable.

As demonstrated above, the existing cable television horizontal ownership limits and ownership attribution rules already permit incumbent MSOs to control access to a sufficient number of subscribers to afford them monopsony power over cable networks, which they can use to disadvantage new entrants. In addition, the ownership attribution rules have permitted MSOs to acquire an interlocking web of interests in cable networks that allows them effectively to control the market for cable programming, and therefore to inhibit the development of alternative distribution channels.

Any relaxation of the cable ownership attribution criteria or the horizontal concentration limits would permit large MSOs to consolidate further their existing market power and therefore retard nascent competition in the multichannel video distribution market. Specifically, increasing the horizontal ownership limits would allow MSOs to expand further the number of subscribers they control, and therefore to increase their monopsony power in the cable programming market to the detriment of new entrants like Ameritech.[66] It is, moreover, clear that MSOs would take advantage of the opportunity to

[66] Leo Hindry, Jr., President of TCI, has argued that the Commission must revise its horizontal ownership cap on cable operators so that they may create additional clusters and expand their national reach to compete efficiently with incumbent local telephone companies. Testimony of Leo J. Hindry, Jr., President, Telecommunications, Inc., Before the Senate Committee on Commerce, Science, and Transportation at 9-10 (July 28, 1998). While Ameritech recognizes that clustering can enable MVPDs to realize certain economic efficiencies, clustering can also facilitate avoidance of the program access requirements by reducing the cost of terrestrial delivery of programming and, therefore, inhibit the development of robust competition in the

expand the number of subscribers they can reach, as demonstrated by AT&T's announced intention to seek additional transactions with cable operators. Relaxing the cable ownership attribution criteria could similarly increase the number of subscribers controlled by particular MSOs, again increasing their monposony power in the programming market. It could also allow MSOs to increase their interests in cable programmers and firms that control essential technologies and services. Relaxing the cable attribution rules could, therefore, afford MSOs the ability to influence such firms to impose excessive or discriminatory rates, terms and conditions for critical programming or essential technology on unaffiliated MVPDs, inhibiting their ability to compete effectively in the MVPD market.

Relaxing the attribution criteria would also allow more programming contracts between cable operators and programmers in which such operators have an ownership or other interest to escape regulatory scrutiny, and increase both horizontal concentration and vertical integration. As a result, it will become that much harder for Ameritech and other new entrants to obtain access to critical programming on reasonable and nondiscriminatory rates, terms and conditions.

The horizontal concentration and ownership attribution issues raised in these proceeding are, therefore, inextricably linked to issues relating to program access, and cannot be addressed independently of the regulations governing such access. Consequently, the Commission should not even consider increasing the cable television

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MVPD market. In any event, it is clear that the Commission need not, as Hindry suggests, increase the horizontal ownership limits for cable operators to realize the benefits of clustering, as demonstrated by the prevalence of clustering even under the existing horizontal ownership limits.

horizontal ownership limits or relaxing the ownership attribution rules until the program access rules have been strengthened and broadened to encompass terrestrially delivered programming and non-vertically integrated cable programming networks, and modified to ensure that MVPD entrants can procure programming on the same terms as those offered to the incumbent MSOs against which they compete in their own markets. Moreover, the Commission should examine closely the effects of cable horizontal concentration and increasing vertical integration between incumbent cable operators and providers of critical technologies and services on the emerging broadband, digital marketplace before considering whether to modify its horizontal ownership and ownership attribution rules.

IV. Conclusion.

For the foregoing reasons, the Commission should not take any action in either of these proceedings that would increase further horizontal concentration or vertical integration in the cable industry (such as increasing the horizontal ownership limits or relaxing the ownership attribution criteria) until the program access rules have been broadened and strengthened, and the Commission has considered the impact of horizontal concentration and vertical integration with suppliers of critical technologies and services on the nascent broadband, digital marketplace.

Respectfully submitted,

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August 14, 1998

Attachment 1

Examples of Competitive Response To Ameritech Market Entry

Competitor	Before Ameritech New Media's Entry	After Ameritech New Media's Entry	Adjacent Non-Competitive Community Served by Incumbent
Time Warner (Franchise sold to MediaOne, 6/98)	Wayne, MI 54 Expanded Basic Channels 6 Premium Channels 2 PPV Channels Expanded Basic $23.95 Disney $11.45 Regional Sports $13.95 Premiums $12.95 Converter/remote $3.37 Total Package $65.67	Wayne, MI 63 Expanded Basic Channels 10 Premium Channels 3 PPV Channels Expanded Basic $22.81 (incl. Disney & Regional Sports) Premiums $9.95 Converter/remote $2.95 Total Package $35.71	Farmington, MI 64 Expanded Basic Channels 10 Premium Channels 3 PPV Channels Expanded Basic $30.48 (incl. Regional Sports) Disney $8.95 Premiums $8.95 Converter/remote $2.40 Total Package 50.78
Cablevision	Berea/North Olmsted, OH 43 Expanded Basic Channels 8 Premium Channels 2 PPV Channels Expanded Basic $19.63 Disney $9.95 Premiums $9.95 Total Package $39.53 Tyson/Holyfield fight $49.95	Berea/North Olmsted, OH 64 EB Channels 11 Premium Channels 5 PPV Channels Expanded Basic $21.95 (incl. Disney) Premiums $9.95 Total Package $31.90 Tyson/Holyfield fight Free	Strongsville, OH 44 Expanded Basic Channels 8 Premium Channels 2 PPV Channels Expanded Basic $23.44 Disney $10.45 Premiums $10.45 Total Package $44.34 Tyson/Holyfield fight $49.95

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Examples of Competitive Response To Ameritech Market Entry

Competitor	Before Ameritech New Media's Entry	After Ameritech New Media's Entry	Adjacent Non-Competitive Community Served by Incumbent
Media One	Canton, Plymouth, MI 49 Expanded Basic Channels 5 Premium Channels 2 PPV Channels Expanded Basic $21.79 Disney $9.69 Regional Sports $11.95 Premiums $9.69 Total Package $53.12	Canton, Plymouth, MI 65 Expanded Basic Channels 12 Premium Channels 5 PPV Channels Expanded Basic $22.95 (incl. Disney & Regional Sports) Premiums $9.95 Total Package $32.90	Ann Arbor, MI 65 Expanded Basic Channels 9 Premium Channels 3 PPV Channels Expanded Basic $26.75 (incl. Disney & Regional Sports) Premiums $9.95 Total Package $36.70
TCI	Berkley, MI 85 Expanded Basic Channels 12 Premium Channels 9 PPV Channels Expanded Basic $32.23 Equip $3.30 Premiums $14.95 Total Package $50.48	Berkley, MI 85 Expanded Basic Channels 12 Premium Channels 9 PPV Channels Expanded Basic $24.95 1st Equip Free For 1 Year Premiums $10.45 Total Package $35.40	Rochester, MI 85 Expanded Basic Channels 12 Premium Channels 9 PPV Channels Expanded Basic $32.23 Equip $3.30 Premiums $10.45 Total Package $45.98

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Examples of Competitive Response To Ameritech Market Entry

Competitor	Before Ameritech New Media's Entry	After Ameritech New Media's Entry	Adjacent Non-Competitive Community Served by Incumbent
TCI	Lincoln Park, MI 48 Expanded Basic Channels 7 Premium Channels 5 PPV Channels Expanded Basic $25.32 Equip $3.30 Disney $10.90 Regional Sports $10.90 Premiums $14.95 Total Package $65.37	Lincoln Park, MI 68 Expanded Basic Channels 12 Premium Channels 2 PPV Channels Expanded Basic $23.95 1st Equip Free Indefinitely (incl. Disney and Regional Sports) Premiums $10.45 Total Package $34.40	Gibraltar, MI 63 Expanded Basic Channels 12 Premium Channels 3 PPV Channels Expanded Basic $26.01 Equip $3.30 (incl. Disney and Regional Sport) Premiums $10.45 Total Package $39.76
Comcast	Southgate, MI 52 Expanded Basic Channels 7 Premium Channels 3 PPV Channels Expanded Basic $24.05 Disney $12.95 Regional Sports $12.95 Premiums $11.95 Total Package $61.90	Southgate, MI 65 Expanded Basic Channels 12 Premium Channels 4 PPV Channels Expanded Basic $23.95 (incl. Disney and Regional Sports) Premiums $12.95 Total Package $36.90	Grosse Isle, MI 65 Expanded Basic Channels 12 Premium Channels 3 PPV Channels Expanded Basic $27.06 (incl. Regional Sports) Disney $ 7.95 Premiums $12.95 Total Package $47.96

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Examples of Competitive Response To Ameritech Market Entry

Competitor	Before Ameritech New Media's Entry	After Ameritech New Media's Entry	Adjacent Non-Competitive Community Served by Incumbent
Comcast	Melvindale, MI 51 Expanded Basic Channels 7 Premium Channels 3 PPV Channels Expanded Basic $25.95 Disney $12.95 Total Package $38.90	Melvindale, MI 65 Expanded Basic Channels 12 Premium Channels 6 PPV Channels Expanded Basic $25.95 (incl. Disney) Total Package $25.95	Harper Woods, MI 60 Expanded Basic Channels 7 Premium Channels 3 PPV Channels Expanded Basic $27.95 Disney $12.95 Total Package $40.90
Coaxial	Columbus, OH 50 Expanded Basic Channel 9 Premium Channels 7 PPV Channels Expanded Basic $29.61 Disney $6.95 Turner Classic Movies $11.95 Total Package $48.51	Columbus, OH 56 Expanded Basic Channels 9 Premium Channels 7 PPV Channels Expanded Basic $26.40 (incl. Disney & TCM) Total Package $26.40	New Albany, OH 53 Expanded Basic Channels 7 Premium Channels 6 PPV Channels Expanded Basic $26.40 (incl. Disney & TCM) Total Package $26.40

Examples of Competitive Response To Ameritech Market Entry

Competitor	Before Ameritech New Media's Entry		After Ameritech New Media's Entry		Adjacent Non-Competitive Community Served by Incumbent	
TCI	Prospect Heights, IL		Prospect Heights, IL		Mount Prospect, IL	
	56 Expanded Basic Channels		62 Expanded Basic Channels		56 Expanded Basic Channels	
	8 Premium Channels		6 Premium Channels		8 Premium Channels	
	5 PPV Channels		2 PPV Channels		5 PPV Channels	
	Expanded Basic	$27.90	Expanded Basic	$27.90	Expanded Basic	$27.90
	Equip	$ 3.30	1st Equip Free Indefinitely		Equip	$ 3.30
	Premiums	$14.40	Premiums	$14.40	Premiums	$14.40
	Total Package	$45.60	Total Package	$42.30	Total Package	$45.60
Jones Intercable	Naperville, IL		Naperville, IL		Aurora, IL	
	55 Expanded Basic Channels		60 Expanded Basic Channels		55 Expanded Basic Channels	
	4 Premium Channels		5 Premium Channels		4 Premium Channels	
	2 PPV Channels		2 PPV Channels		2 PPV Channels	
	Expanded Basic	$23.87	Expanded Basic	$23.87	Expanded Basic	$27.44
	Disney	$ 6.95	(incl. Disney)		Disney	$ 6.95
	Total Package	$30.82	Total Package	$23.87	Total Package	$34.39

ANM CIT
7/29/98

Programming Access and Effective Competition in Cable Television

by

James N. Dertouzos* and Steven S. Wildman**

Prepared for

Ameritech New Media

August 14, 1998

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Executive Summary

Programming Access and Effective Competition in Cable Television

by

James N. Dertouzos* and Steven S. Wildman**

I. Introduction and Summary

Competitors to the incumbent cable companies complain that they are denied access to critical networks and are charged discriminatorily high prices that place them at a significant cost disadvantage to incumbents for the networks they can acquire. This report, which examines these access issues associated with the supply of programming services (primarily cable networks) to multichannel video programming distributors (MVPDs), shows that there are both sound theoretical reasons and empirical evidence for believing that these complaints have merit and warrant attention by policymakers.

For new entrants to compete effectively with incumbents in any industry, they must have fair and equal access to critical inputs. This is no less true for multichannel video programming services. Under current cable competition policies, however, the largest multiple system operators (MSOs) are able to exploit their control over access to millions of cable subscribers to obtain programming on more favorable terms than smaller MSOs, including new entrants. Because this advantage is not grounded in superior efficiency, it is a barrier to effective competition in the multichannel video services industry.

Cable entrants suffer from two handicaps in procuring programming that severely limit their ability to compete effectively with large, incumbent MSOs: (1) They have to pay much higher prices for the networks they package and deliver to subscribers; and (2) Large incumbents can and do find it profitable to deny entrants access to certain types of

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popular networks by either licensing them exclusively for their own use or by acquiring ownership of these networks and exploiting loopholes in existing laws to deny them to competitors. The analysis presented in this report shows that very little of the network pricing advantages from which the largest MSOs benefit can reasonably be attributed to efficiencies realized by the networks in dealing with them, or to efficiencies in the MSOs' own operations. Rather, their ability to negotiate dramatically lower network supply prices is due almost entirely to the tremendous bargaining leverage they realize from their control over access to many millions of cable viewers.

Large size, rather than incumbent efficiencies, also explains the ability of incumbent MSOs to outbid competitive entrants for exclusive rights to popular networks. While exclusivity is sometimes viewed as a vehicle by which entrants can differentiate themselves from incumbents and win customers, exclusive rights always favor incumbents, who, due to their large subscriber counts and greater geographic coverage, find it profitable to outbid entrants for the best programming. Furthermore, once they have acquired exclusivity, incumbents can then profit from bundling the networks they alone can offer with other networks and pricing the bundles in such a way as to render entrants' operations unprofitable.

Neither the pricing nor the exclusivity disadvantages of entrants are trivial in magnitude. Nor are they trivial policy concerns if robust competition is an important policy objective. In fact, our rough calculations suggest that the programming cost disadvantage is large enough to constitute a crippling handicap for cable overbuilders while safeguarding high margins for the incumbent systems of large MSOs. Therefore, new programming access policies are required to address these sources of competitive imbalance if robust competition is to thrive in the multichannel video services industry in the long run.

The programming access problems examined in this report stem from the current combination of inadequate access policy protections and significant horizontal concentration among MSOs. Because the horizontal ownership restrictions and the cable attribution rules were both implemented as protection against the problems posed by high concentration of MVPD subscribers among a few large MSOs, it would be unwise to relax either of these policies without first addressing the shortcomings of the current programming access regulations.

II. Review of Research and Findings

We examined two sources of data on network pricing to get a better sense of the magnitude of the disadvantage higher programming costs constitute for entrants. The first was rate cards for six networks, which were examined as one gauge of the magnitude of the price breaks given large MVPDs compared to smaller purchasers, including new entrants such as cable overbuilders. Maximum discounts averaged just under 15%, with a high of about 24% and a low of approximately 3%, while the number of subscribers required to qualify for the maximum discount ranged from 1.5 million to 5 million. For five of the six networks, 100,000 or more subscribers were required to qualify for the minimum discount. Only the seven largest MSOs have as many as 1.5 million subscribers and only two of these (TCI and Time Warner) have more than 5 million. As new entrants can be expected to start with subscribers bases too small to qualify even for minimum rate card discounts for most networks, the programming cost advantage of incumbents that is built into rate cards can be quite substantial.

It is widely reported that the largest MSOs are able to negotiate prices for programming even lower than those specified on rate cards, and that they are able to negotiate other benefits not available to smaller operators—such as marketing support—that also lower their net programming costs. If this is so, using rate cards to estimate the programming cost disadvantage of entrants may substantially understate its true magnitude. The second source of data we examined suggests that this is, in fact, the case. In their report, *The Economics of Basic Cable Networks*, 1998, Paul Kagan Associates report the top rate card prices (top rates) charged MVPDs, the average (across the industry) discounts off these top rates, and local advertising revenues for the more popular networks. For the 19 basic networks we examined, the mean of their individual average discounts was nearly 45% off the top rate.

This estimate of the programming cost disadvantage of new entrants is likely to understate the magnitude of the true programming cost disadvantage for two reasons. First, the discount figures employed are averages of these networks' discounts across all MPVDs, including the small ones that receive no discounts or small discounts. So the discounts received by the largest MSOs must be larger, and probably considerably larger. Second, it ignores the effect of local cable advertising on MSO license fees. While subscription fees used to account for almost all of a cable system's revenues, local ad sales have been growing in importance. We would expect license fee payments to reflect the value of both sources of revenue to operators. Our empirical analysis of local cable advertising bears this out. Cable system operators pay approximately 52 cents in increased license fees for every dollar they realize from the sale of local advertising time.[1] Furthermore, local ad time is a much more important source of revenue for the large MSOs than for smaller system operators. Thus, to the extent that the large MSOs' license fees include payments for advertising opportunities not available to smaller operators, a straight comparison of per subscriber license fees understates the price advantage of the larger players. That is, the license fees paid by the large MSOs reflect payments both for the subscription fees and advertising revenues the networks make possible. The license fees paid by the small MVPDs reflect payments for the subscription value alone.

Because programming is a major MVPD expense category, the differences between what entrants pay for programming and what the major incumbent MSOs pay has important consequences for both entrant viability and the vigor of competition where it does occur.

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[1] See Appendix B of J. N. Dertouzos and S. S. Wildman, *Programming Access and Effective Competition in Cable Television*, August 14, 1998, which was prepared for Ameritech New Media for this proceeding.

To put this in perspective, a small MVPD carrying the 19 basic networks examined and paying their top rates would pay approximately $27.13 more per subscriber annually than would a MVPD receiving the average industry discount—and even more over and above the amount paid by large MSOs receiving the maximum off-rate card discounts. This is approximately 10 percent of basic service revenues.[2] For a cable system operator with 100,000 subscribers, which would pay at or near the top rate for most networks, this amounts to a more than $2.7 million cost disadvantage annually. If license fees paid by MVPDs are adjusted to reflect the importance of local advertising revenues to the largest MSOs, the entrant disadvantage is even larger than just indicated, rising to as much as $39 per subscriber annually, or $3.9 million for a 100,000 subscriber system.

It is hard to rationalize price differences of this magnitude with the standard efficiency and incentive explanations for quantity discounts. Reduced delivery costs cannot explain such large price differences either, because a network's signal falls automatically on all cable headends within its satellite's footprint. Thus, the incremental cost of making a network available to an additional (wireline) MVPD should be close to zero, regardless of how many subscribers it has.

Costs saved in negotiating with a single MSO supplying access to many viewers rather than reaching the same number of viewers by striking deals with a large number of smaller system operators has also been offered as an explanation for quantity discounts. To assess the credibility of this explanation for the differences in network supply prices paid by large and small MVPDs, we calculated how costly MSO-network negotiations would have to be to explain the differences described above in per subscriber license fees paid by an entrant and an incumbent MSO receiving the average industry discount[3]. For the 19 networks examined, the average negotiation cost required to justify the price

[2] Based on Paul Kagan Associates estimate of an average basic monthly subscription fee of $22.76 in 1997. Paul Kagan Associates, *Economics of Basic Cable Networks*, 1998.

[3] The qualifying MSO size was assumed to be equal to the average number of subscribers to a network supplied by the top 50 MSOs in 1997.

differences observed was just under $800,000, if we did not adjust for the effect of local advertising revenues on license fees, and over $1.1 million if these adjustments were made.[4] Yet, available evidence strongly suggests that the actual cost of negotiating network supply contracts is quite small.

Thus it is hard to avoid the conclusion that the programming cost advantage of the largest MSOs over their smaller competitors is almost solely a reflection of leverage over programmers acquired by bringing ever larger numbers of US cable subscribers under the control of a few very large operators. This finding is consistent with earlier academic research on network-MSO bargaining. It is further supported by the findings of our own econometric study of MSO pricing and patterns of network selection, which suggest that the largest MSOs acquire programming on substantially better terms than smaller cable system operators.[5]

In addition to the programming cost disadvantages just discussed, there are increasing complaints that incumbent MSOs are negotiating exclusive contracts with attractive new networks that deny these networks to competitors, or acquiring ownership interests in these networks and refusing to license them to their competitors by taking advantage of loopholes in existing statutes.[6] There are strong theoretical reasons to expect that, due to their large subscriber bases and extensive geographic reach, incumbent MSOs will always find it profitable to outbid entrants for exclusive rights to popular networks. There is also strong anecdotal evidence that programming exclusivity is a strategy employed primarily by incumbents, rather than entrants, in the cable industry. This evidence is consistent with our own empirical study of regional sports networks, which

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[4] These calculations assume five year network supply contracts. Contracts of this length and longer appear to be fairly common. Calculations based on shorter contracts are also reported in Dertouzos and Wildman, Section II.

[5] See Dertouzos and Wildman, Section II and Appendix A.

[6] For example, as long as they are not distributed by satellite, networks owned by MSOs generally are not subject to the requirement that vertically integrated networks be made available to MSO competitors.

found that systems operated by large, incumbent MSOs are 25% more likely to carry these services than are competitive overbuild systems.

Both the pricing and programming exclusivity disadvantages faced by entrants in the multichannel video programming industry have their roots in the large and increasing fraction of cable subscribers controlled by the largest MSOs, rather than efficiencies attributable to their size. Our analysis suggests that neither of these entrant disadvantages is trivial in magnitude. This has several important policy implications. First, policies governing access to programming should be changed and elaborated in two ways: The standard for determining program access should be revised to guarantee that MVPD entrants can procure programming on financial terms equivalent to those available to the systems of the incumbent cable MSOs they compete against in the entrants' markets—not MVPDs similar in size to the entrants who may be located elsewhere. Because exclusivity arrangements can have a detrimental impact on competition, policies governing exclusivity should also be revised. Second, our evidence indicates that the size threshold beyond which a MSO has a noticeable impact on market performance is below the current levels of market control experienced by the largest MSOs, particularly TCI and Time Warner. Because the programming access problems examined in this report stem from the current combination of inadequate access policy protections and significant horizontal concentration among MSOs, it would be unwise to consider relaxing horizontal ownership restrictions without first thoroughly revising programming access policies. As the ownership attribution rules are yet another form of protection against the problems posed by high concentration of MVPD subscribers among a few large MSOs, the same cautious approach towards revising these rules is also advised.

Programming Access and Effective Competition in Cable Television

I. Introduction

Competitors to the incumbent cable companies complain that they are denied access to critical networks and are charged discriminatorily high prices that place them at a significant cost disadvantage to incumbents for the networks they can acquire. This report, which examines these access issues associated with the supply of programming services (primarily cable networks) to multichannel video programming distributors (MVPDs), shows that there are both sound theoretical reasons and empirical evidence for believing that these complaints have merit and warrant attention by policymakers.

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Specifically, this report shows that problems cable entrants encounter in their attempts to acquire programming severely limit their ability to effectively compete with large incumbent multiple system operators (MSOs) for two reasons: (1) Entrants must pay much higher prices for the networks they package and deliver to subscribers than do the large incumbent MSOs with whom they compete; and (2) Large incumbents can and do find it profitable to deny entrants access to certain types of popular networks by either licensing them exclusively for their own use or by purchasing them and refusing to license them to competitors. Even though there currently are policies regulating the pricing of networks in which large MSOs have substantial ownership interests, the price disadvantage

Executive Summary

Programming Access and Effective Competition in Cable Television

by

James N. Dertouzos[*] and Steven S. Wildman[**]

I. Introduction and Summary

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suffered by entrants applies to vertically integrated networks as well as to those that are independently supplied.

Cable entrants' price disadvantage on independently supplied networks is a consequence of the frequently dramatic discounts the largest MSOs are able to negotiate with network suppliers compared to the prices paid by entrants and small MVPDs generally. For the same reason, small incumbent MSOs also pay much more for vertically integrated networks than do large incumbent MSOs. We show below that very little of the network pricing advantages realized by the largest MSOs can reasonably be attributed to efficiencies networks realize in dealing with them, or to efficiencies in the MSOs' own operations. Rather, their ability to negotiate dramatically lower network supply prices is due almost entirely to the tremendous bargaining leverage they realize from their control over access to many millions of cable viewers.

Large size, rather than incumbent efficiencies, also explains the ability of incumbent MSOs to outbid entrant competitors for exclusive rights to popular programming—rights typically purchased on an exclusive basis at the election of the incumbents. While exclusivity is sometimes viewed as a vehicle by which entrants can differentiate themselves from incumbents and win customers, we show below that the inherent logic of bidding for exclusive rights to programming always favors incumbents due to their large subscriber counts and, typically, greater geographic coverage. Incumbents can then profit from bundling the networks they alone can offer with other networks and setting prices for the bundle at levels that render entrants' operations unprofitable.

Both the pricing and programming exclusivity disadvantages faced by entrants in the multichannel video programming industry have their roots in the large and increasing number of cable subscribers controlled by the largest MSOs, rather than efficiency advantages realized by large incumbents. Our analysis suggests that neither of these entrant disadvantages are trivial in magnitude. In fact, rough calculations suggest that the programming cost disadvantage may be large enough to constitute a crippling handicap for cable overbuilders while safeguarding high margins for the incumbent systems of large MSOs. Therefore programming access policy must be elaborated to address these sources of competitive imbalance if robust competition is to thrive in the multichannel video services industry in the long run.

This report is organized as follows. Section II reports the results of two studies of the prices network suppliers charge cable system operators. Both show that the cost disadvantage faced by entrants in acquiring programming is substantial. We then examine alternative economic explanations for the lower prices charged incumbents and conclude that only bargaining power based on size can credibly explain price differences of the magnitudes we observe. These findings are consistent with Waterman's (1996) theoretical analysis of bargaining between networks and MSOs and Chipty's (1995) empirical study of cable system pricing. We also report results of our own econometric analysis of cable system pricing and program offerings, which provides further evidence of the bargaining advantages realized by the largest MSOs, as well as the favoritism MSOs exhibit toward networks in which they have an equity interest.

While Section II's analysis focuses on the pricing of networks that are available to both entrants and incumbents, the economic logic and consequences of allowing MVPDs to negotiate for exclusive rights to networks are examined in Section III. Theory predicts that large incumbents should have the ability and incentive to systematically outbid entrants for exclusive rights to popular networks (or promising new networks). Evidence, both econometric and anecdotal, is presented which suggests that incumbent MSOs are behaving as theory predicts, with results that are ultimately inimical to healthy video market competition. Current policies affecting the supply of network services to MVPDs are briefly reviewed in Section IV. This review shows that current policy does not adequately address the pricing and access problems identified in this study. Furthermore, because the